Understanding the Basic RRSP Rules

Investing in a Registered Retirement Savings Plan (RRSP) is one of the soundest ways to ensure you enjoy a financially secure retirement.

If you want to maximize the benefits of an RRSP, it is important to have a basic understanding of the regulations that govern them. This publication provides an overview of the current RRSP rules.

RRSP Deduction Limits

The easiest way to find your RRSP deduction limit is to look it up on the Notice of Assessment that Canada Revenue Agency (CRA) sends back to you after you file your annual income tax return. If you would like to verify this amount, here's how to calculate it for yourself.

For 2011, your RRSP contribution amount is based upon your carry forward amount from 2010, plus your current year's contribution amount which is the lesser of $22,450 or 18% of 2010 earned income.

If you are a member of a Deferred Profit Sharing Plan (DPSP) or Registered Pension Plan (RPP), you have one and possibly two more steps. You must deduct your pension adjustment and, if applicable, your net past service pension adjustment (PSPA).

Relatively few taxpayers will have a PSPA. If you do, your company will provide you with details.

Earned Income

The sources of income which qualify as earned income include:

- net employment and business income
- disability payments from the Canada Pension Plan or the Quebec Pension Plan
- royalties
- net rental income
- taxable alimony and separation allowances received
- net research grants
- employee profit sharing plan allocations
- supplementary unemployment benefit plan payments

Items that reduce earned income include:

- net rental losses
- deductible alimony or separation allowances paid
- union or professional dues
- employment expenses

Previous Year's Earned Income

Your RRSP deduction limit is calculated using the previous year's earned income. This means that your 2011 RRSP contribution will be based on your 2010 earned income.

There are two groups of taxpayers for whom this rule has some interesting implications. Anyone who had earned income in 2010, but not in 2011, such as recent retirees, get a bonus contribution year. Unfortunately for those who had no earned income in 2010, but do in 2011, will not be able to make a 2011 RRSP contribution unless they have unused contribution room carried forward from a previous year.

Their 2011 earned income will form the basis for their 2012 RRSP contribution.

Pension Adjustment

If you are a member of a Registered Pension Plan or Deferred Profit Sharing Plan, your employer is required to calculate the value of the benefit which accrued to you during the year. You will find the amount of this benefit, called the pension adjustment, on your annual T4 or T4A. Your 2010 pension adjustment reduces your 2011 RRSP deduction limit.

The pension adjustment attempts to add an element of fairness to the pension system since some pension arrangements are more lucrative than others. If you have a generous pension plan, your pension adjustment will be higher than if you are in a less attractive plan.

Pension Adjustment Reversal

Pension adjustments are calculated assuming that you will remain with your employer until retirement. If you change jobs prior to retirement, you may find that the termination benefit from your pension plan is less than the amount of RRSP contribution room you lost due to the pension adjustment.

The February 1997 federal budget introduced the pension adjustment reversal (PAR) which restores lost RRSP contribution room if your termination benefit is lower than your accumulated pension adjustments.

Your pension plan administrator will calculate the amount of your PAR and notify both you and CRA of any adjustment. CRA will add the value of the PAR to your RRSP contribution room. The PAR only applies to termination benefits received after 1996.

The Carryforward Rules

The carryforward rules provide you with a considerable amount of flexibility with planning your RRSP contribution and deduction.

Prior to 1991, if you did not make your RRSP contribution within 60 days following the end of the year, the opportunity was lost forever. And if you did make a contribution, you were required to take your tax deduction in the appropriate tax year. All that changed with the introduction of the two carryforward provisions.

Deduction Room Carryforward

If, for any reason, you do not wish to take full advantage of the RRSP deduction room available to you this year, you can defer making use of it until a future year.

For example, let's say that you are eligible to make a $22,450 RRSP contribution for 2011, but find it impossible to come up with the full amount. You may carry forward part or all of your deduction room for use in 2012 or some later tax year.

Despite being able to carry forward any unused deduction room indefinitely, if you can possibly make your RRSP contribution each year, you should. If you don't, you lose out on the tax-deferred compounding on the income earned, and it probably won't be any easier to make a double contribution the following year.

Please note that you cannot take advantage of this carryforward provision any further back than 1991. If you are not sure whether you have any unused deduction room, please consult your CRA Notice of Assessment.

Tax Deductibility Carryforward

You don't hear much about this second carryforward provision. However, it allows you to make your RRSP contribution and not claim the tax deduction until some future year when you decide it would be more advantageous from a tax perspective.

This ability to carry forward the tax deduction can be very useful in a year when you have the financial ability to make a contribution, but the tax deduction will be of little or no use.

Keeping in mind that you use the previous year's earned income to determine this year's RRSP deduction limit (i.e. your 2010 earned income will help determine how much you may contribute to your RRSP in 2011), this provision is useful for taxpayers who have an income which fluctuates widely from one year to the next.

For example, a professional who took a sabbatical in 2011 would have no 2011 earned income but would be able to make an RRSP contribution based on her high 2010 income. Unfortunately, the tax deduction would be of little use in 2011. In 2012, when she is again fully employed, her RRSP deduction limit would be zero because she had no 2011 earned income. However, if she made a contribution in 2011 and carried forward the tax deduction, she could claim it against her 2012 taxable income when the deduction will be of most value.

Other examples of individuals who might benefit from this provision include commissioned salespeople, anyone transferred outside of Canada temporarily and individuals who lose their job or take extended maternity leave.

The $2,000 Overcontribution Limit

You are allowed to exceed your RRSP deduction limit by $2,000 without attracting a penalty tax.

The overcontribution limit exists because CRA understands that taxpayers may inadvertently overcontribute to their RRSP. There is a one per cent per month tax penalty for contributions which exceed the combination of your maximum deduction limit and the lifetime $2,000 over-contribution limit.

CALCULATE YOUR RRSP DEDUCTION LIMIT

Previous year's unused deduction room	$ ________
ADD LESSER OF:18% of previous year's earned income OR Current year's RRSP dollar limit	$ ________
LESS Prior year's pension adjustment	$ ________
LESS Past service pension adjustment *(if applicable)*	$ ________
PLUS This year's pension adjustment reversal *(if applicable)*	$ ________
Current year RRSP deduction limit	$ ________

The overcontribuition is not tax deductible when contributed to your RRSP and is taxed when withdrawn. The benefit of overcontributing is that all of the income the overcontribution earns stays in the RRSP and compounds on a tax deferred basis. If you deliberately overcontribute be sure to use up the overcontribution as part of some future year's regular RRSP contribution room.

For example, in some future year, perhaps just before retirement, if your RRSP deduction limit is $10,000, you could contribute $8,000 and take the tax deduction for the $2,000 you have already overcontributed. This would give you a total tax deduction of $10,000 and ensure the $2,000 is not doubly taxed.

Age Restriction

The $2,000 overcontribution room is not available to anyone who is under the age of 18 at any time during the calendar year.

RRSP Contribution Deadline

You have 60 days after the end of the year to make your RRSP contribution for the previous tax year. The deadline for making your 2011 RRSP contribution is February 29, 2012. However you could have made your 2011 RRSP contribution as early as January 1, 2011. In fact, a $5,000 annual RRSP contribution made on January 1st of each year for 25 years and earning a 7 per cent rate of return, will be worth over $25,000 more than if the contribution was made 14 months later at the RRSP deadline.

Beginning and Maturing Your RRSP

If you have qualifying earned income, you can open an RRSP. Even a child who has earned income may contribute to an RRSP. However, to generate earned income for RRSP purposes you must file an income tax return, even if there is no tax liability.

Your RRSP may continue until the end of the year in which you celebrate your 71st birthday. At that time you must collapse your RRSP and either take the proceeds in cash or transfer the funds to one or more of the RRSP maturity options which allow you to receive your money back over a period of years.

Taxation of RRSPs

Your RRSP contributions are tax deductible and continue to grow on a tax-deferred basis until they are withdrawn from the plan.

When money is withdrawn from your RRSP, it is considered part of your taxable income for that year. You will pay tax on the money withdrawn at your marginal tax rate.

Keep Good Records

When you take advantage of the carryforward provisions or make a deliberate overcontribution, it becomes imperative that you keep good records. A clear audit trail not only comes in handy during discussions with CRA, but also serves as a way of refreshing your own memory or alerting your executor to some potentially unclaimed tax deductions.

If you have any questions regarding any of the RRSP rules and how they impact your particular situation or would like to learn more about RRSP maturity options,[1] your BMO Nesbitt Burns Investment Advisor will be pleased to provide you with additional information.

[1] Ask your Investment Advisor for our article called *Your RRSP Maturity Options*.

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